KEYWEST
ENERGY CORPORATION

1998 Annual Report

Year Ended
December 31, 1998

ABOUT THE COMPANY

KeyWest Energy Corporation (formerly San Fernando Mining Company Ltd.) is a well-capitalized public company which has redirected its business focus from mining into oil and gas in the Western Canadian sedimentary basin. The new management team has a successful background in the oil and gas industry. KeyWest's corporate strategy is to build a new oil and gas company through corporate mergers, property acquisitions and drilling opportunities.

KeyWest's shares trade on the Alberta Stock Exchange under the symbol "KWE".

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ANNUAL MEETING

KeyWest invites its shareholders and other interested parties to attend the Company's Annual Meeting at 3:00 p.m. (local time) on Wednesday, May 26, 1999 in the Banff Room of the Westin Hotel at 4th Avenue and 3rd Street S.W. in Calgary, Alberta.

REPORT TO SHAREHOLDERS

This 1998 Annual Report of KeyWest Energy Corporation (formerly San Fernando Mining Company Ltd.) covers the fiscal period December 31, 1998. In mid-1998, consistent with standard practice in the oil and gas industry, the Company changed its year-end from May 31st to December 31st. As a consequence this Report encompasses only seven months of results.

KeyWest has undergone a number of changes over the past year and the Company's new name is a reflection of those changes. An experienced management team with a successful background in the oil and gas industry was brought into the Company last spring to redirect its business focus from mining into oil and gas in Western Canada's sedimentary basin. KeyWest's Board of Directors was also expanded to include a group of seasoned oil and gas industry veterans. The strategy of your new management team is to seek corporate mergers as well as property acquisitions. We are targeting oil and gas companies and properties which we judge to have upside potential for additional drilling or reservoir enhancement.

The oil market fundamentals today are very similar to the oil price collapse of 1986. Oil prices during 1998 averaged $14.42 U.S. per barrel – some 40% below 1997 levels. Oil prices have since dropped to twelve-year lows and are now around $14.00 U.S. per barrel as a result of an oversupply of oil in the world and falling demand, particularly in southeast Asia. Natural gas prices have also started to soften and are down 15% from last year to approximately $1.80 U.S. per mcf as a result of milder winter temperatures and high storage levels.

Twelve months of low oil prices are now having a noticeable impact on the oil and gas industry. Falling cash flows and increasing debt levels are curtailing capital spending and will cause many of the smaller oil leveraged firms to sell assets or consider corporate mergers. This trend will become even more pronounced in the coming months as the effects of prevailing low oil prices are felt. This translates into great opportunities for cash rich companies like KeyWest. There is no better time to build a new company than during the lower part of the price cycle when property values become more realistic. Supply/demand imbalances have shifted many times in our industry and over the next year we will undoubtedly see the pendulum again swing toward higher prices.

As an important first step toward creating a new oil and gas company, your management significantly increased KeyWest's cash position during 1998. Building on the Company's asset base of $8.5 million in cash, the new management team injected $1.5 million of additional equity into the Company last April. This was followed by a $2.1 million private placement in August. In December a corporate merger was completed with Colt Energy Inc., another cash-rich company with $8 million in the bank. The net result is that KeyWest Energy now has $20 million in cash, no debt and some 31.84 million shares outstanding.

Fiscal 1999 will be a building year for the Company. Given our strong financial position and experienced management team we are confident that the coming year will give rise to many opportunities to create value for our shareholders through oil and gas mergers, property acquisitions and drilling.

On Behalf of the Board of Directors

Harold V. Pedersen

President

March 8, 1999

MANAGEMENT'S DISCUSSION AND ANALYSIS

Financial Condition

At December 31, 1998 KeyWest had working capital of $19,936,949 and no debt. During the seven month period commencing June 1, 1998 and ending December 31, 1998 the Company's sole source of revenue was interest income of $337,451. Operating expenses during the seven month period were $448,357.

At December 31, 1998 the Company's shares in two publicly-traded mining companies were written down to reflect their then-current market value of $47,922.

Business Developments

Two significant transactions were concluded by the Company during the seven month reporting period. In September, 1998 KeyWest concluded a private placement of 2,376,427 common shares at $0.90 per share for total proceeds to the Company of approximately $2.14 million. Seventy percent of the shares issued under the private placement received "flow-through" benefits for the 1998 taxation year.

On December 17, 1998 KeyWest completed a merger with Colt Energy Inc. pursuant to which the Company issued 12,783,124 common shares to acquire assets comprising cash together with oil and gas properties collectively totalling $8.6 million in value ($8.0 million net of acquisition costs of approximately $630,000). The oil and gas assets were subsequently sold at a price equal to their carried value of $764,000.

Outlook and Business Risks

Management plans to build a profitable oil and gas company through a combination of mergers, acquisitions and drilling opportunities. The current low oil price environment will create opportunities in the coming months for well-funded companies such as KeyWest. The management team has a proven track record – having previously founded and run two successful oil and gas companies – and the Board of Directors are experienced and knowledgeable.

Year 2000

Concerns revolving around the "Year 2000" relate to business complications that may arise because many computer programs and operating systems were designed to use only two digits rather than four to record the year. On January 1, 2000, when the year is designated as "00", certain computer systems could either fail completely or create erroneous data as a result of misinterpretation of the year. KeyWest's main asset is cash and instruments of deposit with respect to which the Company has requested written assurances from its banking institutions as to their year 2000 readiness. Apart from the foregoing, KeyWest does not currently have any material Year 2000 issues, mainly because the Company has been essentially inactive for some period of time. Nonetheless, management is cognizant of the potential for problems and will take measures to ensure that the data bases associated with any new corporate or property acquisitions are either Year 2000 compliant or are modified to comply.

MANAGEMENT'S STATEMENT OF RESPONSIBILITY FOR FINANCIAL REPORTING

The accompanying consolidated financial statements of the Company have been prepared by management in accordance with generally accepted accounting principles and the financial and operating information presented throughout this annual report is consistent with that which is shown in the financial statements. The integrity of data in these financial statements is the responsibility of management and, to this end, management maintains a system of internal controls to provide reasonable assurance that all assets are safeguarded and to produce reliable accounting records.

External auditors appointed by the shareholders have conducted an independent examination of corporate and accounting records in order to express their opinion on the financial statements for the seven month period ended December 31, 1998 and for the fiscal years ended May 31, 1998 and 1997. The Audit Committee, consisting of external directors, has reviewed these statements with management and the auditors and has reported to the Board of Directors. The Board has approved the financial statements of KeyWest which are contained in this annual report.

Harold V. Pedersen
President

Mary C. Blue
Executive Vice-President

Calgary, Alberta
February 19, 1999

AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheet of KeyWest Energy Corporation as at December 31, 1998 and the consolidated statements of operations and deficit and cash flow for the seven month period ended December 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1998 and the results of its operations and cash flow for the seven month period ended December 31, 1998 in accordance with generally accepted accounting principles.

The comparative figures as at May 31, 1998 and for the years ended May 31, 1998 and 1997 were reported on by another firm of chartered accountants.

Calgary, Alberta
February 19, 1999

KPMG LLP
Chartered Accountants

KEYWEST ENERGY CORPORATION
Consolidated Balance Sheet

	December 31, 1998	May 31, 1998
Assets		
Current assets:		
Cash	$20,274,722	$10,053,018
Receivables and prepaids	72,233	56,835
Marketable securities (note 4)	47,922	84,020
Notes receivable (note 5)	299,707	–
	20,694,584	10,193,873
Capital assets	35,536	31,381
	$20,730,120	$10,225,254
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	$ 757,635	$ 61,694
Shareholders' equity:		
Share capital (note 6)		
Issued: December 31, 1998 - 31,844,702; May 31, 1998 - 16,828,651	20,231,178	10,275,249
Deficit	(258,693)	(111,689)
	19,972,485	10,163,560
	$20,730,120	$10,225,254

See accompanying notes to financial statements.

On behalf of the Board:

Director

Director

KEYWEST ENERGY CORPORATION
Consolidated Statement of Operations and Deficit

	Seven month period ended December 31, 1998	Years ended May 31, 1998	1997
Revenue:			
Interest	$ 337,451	$ 323,740	$ 224,443
Expenses:			
Salaries and benefits	169,554	76,443	–
Office services	62,721	111,140	86,980
Investor relations	40,525	23,850	15,516
Audit and legal fees	36,801	43,353	54,194
Rent	36,372	28,871	14,270
Filing and transfer agent fees	33,782	33,038	14,603
Consulting and management fees	20,652	35,000	64,477
Bad debts	14,985	14,985	–
Corporate capital tax	13,179	12,146	39,939
Travel	8,613	21,040	10,574
Telephone	5,913	6,516	8,193
Amortization	5,260	12,506	14,567
Foreign exchange gain	–	(52,490)	(11,711)
Mineral property expenditures	–	–	78,034
	448,357	366,398	389,636
Loss before the following	(110,906)	(42,658)	(165,193)
Write-down of marketable securities	(36,098)	(48,750)	–
Loss on sale of capital assets	–	(5,139)	(16,938)
Loss on sale of investments	–	(2,077,149)	24,737
Write-down of investments	–	(1,202,722)	–
Write-down of capital assets	–	(30,000)	–
Net loss for the period	(147,004)	(3,406,418)	(157,394)
Deficit, beginning of period	(111,689)	(11,359,031)	11,201,637
Reduction of stated capital (note 6)	–	14,653,760	–
Deficit, end of period	$ (258,693)	$ (111,689)	$ (11,359,031)
Loss per share	$ (0.01)	$ (0.24)	$ (0.01)

See accompanying notes to financial statements.

KEYWEST ENERGY CORPORATION
Consolidated Statement of Cash Flow

	Seven month period ended December 31, 1998	Years ended May 31, 1998	Years ended May 31, 1997
Cash provided by (used in):			
Operations:			
Net loss for the period	$ (147,004)	$ (3,406,418)	$ (157,394)
Items not affecting cash:			
Write-down of marketable securities	36,098	48,750	–
Amortization	5,260	12,506	14,567
Loss on sale of capital assets	–	5,139	16,938
Loss on sale of investments	–	2,077,149	–
Write-down of investments	–	1,202,722	12,469
Write-down of capital assets	–	30,000	–
	(105,646)	(30,152)	(125,889)
Change in non-cash working capital	43,836	12,469	611,815
	(61,810)	(17,683)	485,926
Financing:			
Shares issued on acquisition (note 3)	7,970,097	–	–
Shares issued on private placement	2,138,784	1,573,037	–
Share issue costs	(54,097)	–	–
Shares acquired and cancelled	(98,855)	–	–
Proceeds from exercise of options	–	–	100,000
	9,955,929	1,573,037	100,000
Investments:			
Acquisition, net of cash (note 3)	(333,000)	–	–
Proceeds on sale of oil and gas properties	764,000	–	–
Proceeds on sale of capital assets	–	5,000	–
Purchase of capital assets	(9,415)	(26,855)	(24,384)
Proceeds on sale of investments	–	1,044,687	–
Change in non-cash working capital	(94,000)	–	–
	327,585	1,022,832	(24,384)
Increase in cash	10,221,704	2,578,186	561,542
Cash, beginning of period	10,053,018	7,474,832	6,913,290
Cash, end of period	$ 20,274,722	$ 10,053,018	$ 7,474,832

See accompanying notes to financial statements.

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1. Nature of operations:

A Special Meeting of the shareholders of San Fernando Mining Company Ltd. was held May 14, 1998 at which time approval was granted to make application for continuance under the Canada Business Corporation Act, thereby effecting a change from British Columbia to the Federal jurisdiction. At the same time, approval was also granted to change the Company name to KeyWest Energy Corporation and to change the focus of the Company to the acquisition, exploration and development of oil and gas properties. The certificate of continuance was issued on May 25, 1998 approving these changes. The Company has changed its fiscal year end from May 31 to December 31.

2. Significant accounting policies:

(a) Basis of presentation:

The consolidated financial statements have been prepared by management in Canadian dollars in accordance with accounting principles generally accepted in Canada. In all material respects, these accounting principles are generally accepted in the United States except as described in Note 11.

(b) Oil and gas operations:

The Company follows the full cost method of accounting for oil and gas operations. All costs of exploring for and developing oil and gas reserves are capitalized and accumulated in cost centres on a country-by-country basis. Such costs include land acquisition costs, geological and geophysical charges, carrying charges on properties, costs of drilling both productive and non-productive wells and overhead charges directly related to acquisition, exploration and development activities.

The costs in each cost centre, including the costs of production equipment, are depleted and depreciated using the unit-of-production method based on the estimated gross proved reserves. Natural gas reserves and production are converted to equivalent barrels of crude oil based on relative energy content.

The costs of acquiring and evaluating significant unproved properties are initially excluded from depletion calculations. These unevaluated properties are assessed periodically to ascertain whether impairment has occurred. When proved reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion.

The capitalized costs less accumulated depletion and depreciation in each cost centre are limited to an amount equal to the estimated future net revenue from proved reserves (based on prices and costs at the balance sheet date) plus the cost (net of impairments) of unproved properties. The total capitalized costs less accumulated depletion and depreciation, site restoration provision and deferred income taxes of all cost centres is further limited to an amount equal to the future net revenue from proved reserves plus the cost (net of impairments) of unproved properties of all cost centres less estimated future site restoration costs, general and administrative expenses, financing costs and income taxes.

Proceeds from the sale of oil and gas properties are applied against capitalized costs, with no gain or loss recognized, unless such a sale would significantly alter the rate of depletion and depreciation.

(c) Capital assets:

Capital assets are recorded at cost, net of write-downs, and amortized over their useful lives on the declining balance method at the following annual rates:

Office equipment and furniture	20%
Computer equipment	30%

In the year an asset is purchased, the amortization rate is one-half of the annual rate.

(d) Income taxes:

The Company follows the deferral method in providing for income taxes.

(e) Flow-through shares:

The Company finances a portion of its activities with flow-through share issues whereby the tax benefits on expenditures are renounced to the subscribers. Share capital is reduced by the estimated tax cost as a result of the renunciation.

(f) Foreign currencies:

Current assets and liabilities denominated in foreign currencies are translated at the exchange rate on the balance sheet date. Oil and gas properties are translated at historical rates. Revenues, costs and expenses are translated at average rates of exchange prevailing during the period. Gains and losses on foreign currency transactions are included in income.

(g) Loss per share:

Loss per share computations are based on weighted average number of common shares outstanding during the period. Fully diluted per share amounts have not been presented as shares issuable on stock options and warrants have an anti-dilutive effect.

(h) Comparative figures:

Certain prior period figures have been reclassified to conform with the current financial statement presentation.

3. Acquisition:

Effective December 17, 1998, the Company issued 12,783,124 common shares with a fair value of $8,625,800 (based on an average trading share price of the Company's common shares prior to the acquisition) in exchange for all of the issued and outstanding shares of Colt Energy Inc. ("Colt"). This transaction is accounted for by the purchase method with the results of the operations of Colt included from the effective date.

The net assets acquired and the consideration paid are summarized as follows:

Net assets acquired:		
Cash		$ 8,292,800
Note receivable		119,707
Accounts receivable		30,293
Capital assets:		
U.S. oil and gas properties	$ 435,000	
Canadian oil and gas properties	329,000	764,000
		9,206,800
Less: Accounts payable and accrued liabilities		(581,000)
		$ 8,625,800
Consideration paid:		
12,783,124 common shares		$ 7,970,097
Acquisition costs		655,703
		$ 8,625,800

4. Marketable securities:

Marketable securities consist of shares of two Canadian publicly traded companies and are carried at the lower of cost and quoted market value.

	Marketable securities	Investments
Balance, May 31, 1997	$ 62,400	$ 4,394,928
Proceeds from sale of investments	–	(1,044,687)
Loss on sale of investments	–	(2,077,149)
Writedown to market value	(48,750)	(1,202,722)
Reclassification	70,370	(70,370)
Balance, May 31, 1998	84,020	–
Writedown to market value	(36,098)	–
Balance, December 31, 1998	$ 47,922	$ –

5. Notes receivable:

Included in notes receivable is $180,000 from the purchaser of oil and gas properties sold in 1998. In January 1999, $90,000 of the note was paid. The balance bears interest at the prime interest rate charged for Canadian dollar commercial loans plus ½ percent. The note is secured by the properties.

Included in notes receivable is $119,707 due on demand from a former employee of Colt. In February 1999, this amount was paid in full.

6. Share capital:

The Company is authorized to issue an unlimited number of common shares together with an unlimited number of preferred shares issuable in series.

Issued and outstanding:

Common Shares	Number of shares	Amount
Balance, June 1, 1996	13,747,881	$ 23,255,972
Exercise of options	100,000	100,000
Balance, June 1, 1997	13,847,881	23,355,972
Reduction of stated capital		(14,653,760)
Private placement	2,980,770	1,573,037
Balance, May 31, 1998	16,828,651	10,275,249
Shares issued on acquisition (note 3)	12,783,124	7,970,097
Private placement of flow-through shares	2,376,427	2,138,784
Shares acquired and cancelled	(143,500)	(98,855)
Share issuance costs		(54,097)
Balance, December 31, 1998	31,844,702	$ 20,231,178

Reduction of stated capital:

At a Special Meeting of Shareholders held on May 14, 1998, approval was granted to reduce the capital attributed to the common shares by $14,653,760 which represented the accumulated deficit as at February 28, 1998.

Private placement:

In May 1998, the Company concluded a private placement to the management and directors for proceeds of $1,573,037 by issuing 2,884,615 common shares at $0.52 per share and 96,155 common shares at $0.76 per share.

Private placement of flow-through shares:

In August 1998, the Company issued 2,376,427 common shares at $0.90 per share for proceeds of $2,138,784. Under the terms of the private placement, $1,497,152 is to be expended on exploration and development drilling prior to December 31, 1999.

Shares acquired and cancelled:

During the period ended December 31, 1998, the Company purchased and cancelled 143,500 shares for aggregate consideration of $98,855. Share capital has been reduced by this amount.

As at December 31, 1998, the following share purchase options are outstanding:

	Number	Exercise price	Expiration date
Directors	180,000	$ 1.00	February 5, 2001
Directors, officers and staff	1,450,000	0.65	February 26, 2003
	1,630,000		

Warrants and agents options:

	Number	Exercise price	Expiration date
KeyWest A warrants	2,015,476	$ 1.01	September 22, 1999
KeyWest B warrants	926,786	1.01	September 25, 1999
KeyWest C warrants	4,166,667	2.69	November 7, 1999
KeyWest agent options	416,667	2.55	November 7, 1999
	7,525,596		

The warrants and agents options were issued in exchange for issued and outstanding share purchase warrants and agents options of Colt at the date of acquisition. Each warrant and option entitles the holder to acquire one common share of the Company.

7. Related party transactions:

During the year ended May 31, 1998 the Company paid a total of $76,443 (1997 - nil) to full-time officers for salaries and benefits. The Company also paid $94,650 (1997 - $119,346) to companies controlled by a director and previous president for management, accounting and secretarial services.

8. Income taxes:

The provision for income taxes differs from the amount obtained by applying the combined Federal and Provincial tax rate of 44.6% to the net loss. The difference relates to the following:

	Seven month period ended December 31, 1998	Years ended May 31, 1998	1997
Net Loss	$ (147,004)	$ (3,406,418)	$ (157,394)
Expected recovery	(65,564)	(1,519,262)	(70,198)
Unrecognized benefit of losses	65,564	1,519,262	70,198
Reported income taxes	$ –	$ –	$ –

The Company has non-capital losses for income tax purposes estimated to aggregate $2,326,000 at December 31, 1998. Non-capital losses may be carried forward and applied to reduce future taxable income and taxes otherwise payable as follows. The benefit of the loss carry forwards has not been recognized in these financial statements.

1999	$ 32,000
2000	558,000
2001	81,000
2002	437,000
2003	1,089,000
2004	93,000
2005	36,000
	$ 2,326,000

As at December 31, 1998 the Company also has the following approximate tax deductions that are available to offset future taxable income or associated revenue items:

Capital losses	$ 8,540,000
Undepreciated capital cost	150,000
Canadian development expenses	139,000
Canadian exploration expenses	608,000
Share issue costs	927,000

The non capital losses and tax deductions are subject to confirmation by taxation authorities.

9. Financial instruments:

The carrying amounts of the Company's financial assets and liabilities approximate their fair values at December 31, 1998.

10. Uncertainty due to the Year 2000 Issue:

The Year 2000 Issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the Year 2000 Issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant system failure which could affect an entity's ability to conduct normal business operations. It is not possible to be certain that all aspects of the Year 2000 Issue affecting the entity, including those related to the efforts of customers, suppliers, or other third parties, will be fully resolved.

11. Reconciliation to United States generally accepted accounting principles ("US GAAP"):

Income taxes:

In accordance with the Financial Accounting Standards Board Statement No. 109 (SFAS 109), accounting principles generally accepted in the United States requires that income taxes be accounted for by the liability method. Under this method, deferred tax assets and liabilities are determined based on differences between the financial statement reporting and the tax bases of the assets and liabilities and are measured at the enacted tax rates that will be in effect when the differences are expected to reverse. Such differences principally arise from the timing of income and expense recognition for accounting and tax purposes.

The application of SFAS 109 would have no material effect on assets, liabilities or operations for the periods presented in these financial statements as any deferred assets would be eliminated by the recording of a valuation allowance.

CORPORATE INFORMATION

MANAGEMENT

Harold V. Pedersen, B.Comm., P.Land
President

Mary C. Blue, B.A.
Executive Vice-President

Steve Sugianto, M.Sc., P.Eng.
Engineering Manager

Garry L. West, B.Sc., P.Eng.
Vice-President – Engineering & Production

DIRECTORS

Ronald L. Belsher, C.A.*
Calgary, Alberta

Mary C. Blue, B.A.**
Calgary, Alberta

John J. Brown, C.A.*
Vancouver, B.C.

David P. Crevier, LLB
Montreal, Quebec

Alain Lambert, LLB***
Montreal, Quebec

Hugh Mogensen, P.Geol.**
Victoria, B.C.

Harold V. Pedersen, B.Comm.**
Calgary, Alberta

Lyle D. Schultz***
Calgary, Alberta

J. Ronald Woods, B.Comm.*
Toronto, Ontario

* Audit Committee
** Executive Committee
*** Director Elect

HEAD OFFICE

2310, 520 – 5th Avenue S.W.
Calgary, Alberta T2P 3R7
Telephone: (403) 261-2766
Facsimile: (403) 234-9637
Website: www.keywestenergy.com

STOCK EXCHANGE LISTING

Alberta Stock Exchange
(Trading Symbol: KWE)

REGISTRAR AND TRANSFER AGENT

Montreal Trust Company
Calgary, Alberta

BANKERS

Canadian Imperial Bank of Commerce
Oil & Gas Group
Calgary, Alberta

AUDITORS

KPMG LLP
Calgary, Alberta

SOLICITORS

Burnet, Duckworth & Palmer
Calgary, Alberta

Colby, Monet, Demers, Delage & Crevier
Montreal, Quebec

KEYWEST
ENERGY CORPORATION